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Auditing, Accounting and Property Valuation Institute of Lithuania

International Accounting Standards (IAS) Workshop

October 24-24, 2001

Vilnius, Lithuania

International Accounting Standards (IAS) Workshop

Wednesday, October 24, 2001
Vilnius, Lithuania

9:00 – 9:15	**Welcome** **Geoffrey Mazullo** Director, Partners for Financial Stability (PFS) Program
9:15 – 10:00	**IAS 1 Presentation of Financial Statements** **David Cairns** Director, International Financial Reporting Author, International Accounting Standards Survey 2000 Senior Visiting Fellow, London School of Economics and Political Science Secretary-General, International Accounting Standards Committee (1985-94)
10:00 – 10:30	**Questions and Discussion**
10:30 – 11:00	***C O F F E E B R E A K***
11:00 – 12:15	**IAS 2 Inventories, IAS 7 Cash Flow Statements** **David Cairns**
12:15 – 12:45	**Questions and Discussion**
12:45 – 14:00	***L U N C H***
14:00 – 15:30	**IAS 12 Income Taxes, IAS 14 Segment Reporting** **David Cairns**
15:30 – 16:00	***C O F F E E B R E A K***
16:00 – 16:30	**Questions and Discussion**

International Accounting Standards (IAS) Workshop

Thursday, October 25, 2001
Vilnius, Lithuania

9:00 – 10:00	**IAS 16 Property, Plant and Equipment, IAS 17 Leases** **David Cairns**
10:00 – 10:30	**Questions and Discussion**
10:30 – 11:00	***C O F F E E B R E A K***
11:00 – 11:45	**IAS 19 Employee Benefits** **David Cairns**
11:45 – 12:15	**IAS 33 Earnings per Share** **David Cairns**
12:15 – 12:30	**Questions and Discussion**
12:30 – 12:45	**Closing Remarks** **Michael D. Sessums** **Economics Officer** **Embassy of the United States of America** **Vilnius, Lithuania**
12:45 – 14:00	***L U N C H***

IAS Workshop

Vilnius, Lithuania,

24-25 October 2001

David Cairns

IAS 1 *Presentation of Financial Statements*

Key Points

Financial Statements

- Balance sheet
- Income statement
- Statement of changes in equity
- Cash flow statement
- Accounting policies
- Notes

IAS 1 (revised), 7

Fair Presentation

- Financial statements should ‘present fairly’ position, performance and cash flows
- Application of IAS, with appropriate disclosure, virtually always results in ‘fair presentation’
- If compliance is ‘misleading’, depart from IAS
  – ‘extremely rare circumstances’

‘Fair Presentation’ IAS Departure

- Disclose
  - financial statements ‘present fairly’
  - departed from IAS to achieve fair presentation
  - nature of departure, including IAS treatment
  - reason why IAS treatment is ‘misleading’
  - treatment adopted
  - financial impact of departure from IAS

Disclosure of IAS Compliance

- Disclose ‘fact’ of compliance
- Do *not* disclose IAS compliance if do *not* comply with all IAS/SIC interpretations
- Following statements are misleading
  - ‘*complying with the significant IAS requirements*’
  - ‘*in compliance with IAS accounting requirements*’

IAS 1 (revised), 11 and 14

Accounting Policies

- Should comply with IAS
- When no IAS requirement, use policies that ensure that financial statements are:
  - relevant to decision-making needs of users
  - represent faithfully results and position
  - reflect economic substance, not merely legal form
  - neutral (free from bias)
  - prudent
  - complete in all material respects

Going Concern

- Use going concern basis unless:
  - intention to liquidate
  - intention to cease trading
- If use other basis, disclose
  - basis used and reason for not using going concern basis
- Disclose any uncertainties which cast significant doubt on ability to continue as a going concern

IAS 1 (revised), 23

Offsetting - Balance Sheet

- Not permitted unless required or permitted by IAS
  IAS 1 (revised), 33

- Required for financial assets and financial liabilities when:
  - legal right of set off and either
  - intend to settle on net basis or
  - realise asset and settle liability simultaneously

  IAS 32, 33

Offsetting - Income Statement

- Income and expenses should be offset when:
  - required or permitted by IAS
  - gains, losses and expenses from similar transactions and not material

  IAS 1(revised), 34

- Banks - <u>permitted</u> when related to hedges or assets and liabilities which have been offset

  IAS 30, 13

Current:Non-Current

- Choose whether to present separate classifications
- If *not* separately classified
  – present assets and liabilities in order of liquidity
- For each item, disclose amounts expected to be recovered or settled after more than 12 months
  – if combined with items expected to be recovered or settled in less than 12 months

Current Assets

- Expected to be realised, sold or consumed in normal course of operating cycle

or

- Held primarily for trading purposes <u>or</u> short-term and expected to be realised within year of balance sheet date

or

- Cash or cash equivalent, not restricted in use

Current Liabilities

- Expected to be settled in normal course of operating cycle

or

- Due to be settled within year of balance sheet date
  IAS 1 (revised), 60
- Continue to classify as long-term if:
  – intend to refinance on long-term basis
  – intention supported by agreement completed before approval of financial statements

  IAS 1 (revised), 63

Current Liabilities

- Continue to classify long-term interest bearing liability as long-term if:
  - due to be settled within 1 year of balance sheet date *and*
  - intend to refinance on long-term basis *and*
  - intention supported by agreement completed before approval of financial statements

IAS 1 (revised), 63

Balance Sheet Format

- Minimum line items
  - no prescribed order or format
- Line items not limited to IAS defined terms
- Separate line items for assets measured on different bases
- Further sub-classifications in notes

IAS 1 (revised), 66 to 73

Income Statement Format

- Minimum line items
- Analysis of expenses by nature or function
- If analysis based on function
  - disclose depreciation, amortisation and staff costs
- Disclose dividends per share, declared or proposed

IAS 1 (revised), 75 to 85

Statement of Changes in Equity

Separate component of financial statements showing

- net profit or loss for the period
- items recognised in equity (including total)
- accounting policy changes and correction of fundamental errors (IAS 8 benchmark treatment)

IAS 1 (revised), 86

Changes in Equity

Separate component of financial statements or notes

- Transactions with, distributions to, owners
- Accumulated profit and loss
- Reconciliation of each class of:
  - equity capital
  - share premium
  - reserve

IAS 1 (revised), 86

Notes

- Basis of preparation of financial statements
- Accounting policies
- Disclosures required by IASs
- Additional information necessary for ‘fair presentation’
- ‘Systematic manner’ - cross referenced

IAS 1 (revised), 91

IAS 2 *Inventories*

Key Points

Inventories

- Measure at the lower of cost and net realisable value
- Cost:
  - all costs of purchase and conversion and other costs incurred to bring inventories to present location and condition
- Net realisable value
  - selling price less costs of completion and sale

Cost

- Specific identification
  - some case - required; other cases - not practicable
- FIFO or weighted average (*benchmark*)
- LIFO (*allowed alternative*)
  - same formula for similar inventories (SIC 1)
- Standard costs, retail method etc.
  - use if approximate cost

Disclosure

- Accounting policy and cost formula
- Classification of inventories
  - raw materials
  - spare parts and supplies
  - work in progress
  - finished goods
- Inventories carried at net realisable value
- Cost of goods sold

IAS 7 *Cash Flow Statement*

Key Points

Cash Flow Statement

- Changes in cash and cash equivalents
  - operating
  - investing
  - financing
- Operating cash flows
  - direct method
  - indirect method

Cash and Cash Equivalents

- Cash
  - cash on hand
  - demand deposits
- Cash equivalents
  - short-term highly liquid investments, subject to insignificant changes in value
  - bank overdrafts (liabilities)

IAS 16 *Property, Plant & Equipment*

Key Points

Property, Plant and Equipment

- Recognition standard added *(IAS 16, 8)*
- Depreciation (replaces IAS 4)
- Subsequent measurement based on:
  - cost *(benchmark)*
  - fair value *(allowed alternative)*

Depreciation *(benchmark)*

- Systematic allocation of depreciable amount over useful life
- Depreciable amount
  - cost *less* residual value
- Residual value
  - proceeds at end of useful life
  - determine at date of acquisition

Impairment of PPE (IAS 36)

- Any indications that asset may be impaired?
  - recoverable amount < carrying amount
- If ‘yes’, estimate recoverable amount
  - higher of net selling price and value in use

Recoverable Amount

Recoverable amount

=

higher of

Net selling price

Value in use

Impairment of PPE (IAS 36)

- Any indications that asset may be impaired?
  - recoverable amount < carrying amount
- If ‘yes’, estimate recoverable amount
  - higher of net selling price and value in use
- If carrying amount > recoverable amount
  - reduce carrying amount to recoverable amount
  - this is *not* an allowed alternative revaluation

Revaluation of PPE (*allowed alternative*)

- Fair value at date of revaluation
- Revalue entire class
- Revalue regularly such that carrying amount does not differ materially from fair value
- International valuation standards (IVS)
- Same impairment test (IAS 36)

Depreciation (*allowed alternative*)

- Systematic allocation of depreciable amount over useful life
- Depreciable amount
  - fair value *less* residual value
- Residual value
  - proceeds at end of useful life
  - determine at date of valuation

IAS 17 *Leases*

Key Points

Sales versus Lease

- Sale
  - transfer significant risks and rewards of ownership
  - seller has no continuing managerial involvement/ control
- Lease
  - right to use an asset for an agreed period of time
  - *may* transfer significant risks and rewards of ownership

Finance Leases

- Finance lease
  - transfers substantially all the risks and rewards incident to ownership of an asset from the lessor to the lessee
- Lessor
  - acquires asset and rents to lessee
- Lessee
  - pays rent

Operating Leases

- Operating lease
  - does *not* transfer substantially all the risks and rewards incident to ownership of an asset from the lessor to the lessee
- Lessor
  - acquires asset and rents to lessee
- Lessee
  - pays rent

Indicators of Finance Leases

- Ownership transferred to lessee at end of lease
- Lessee has option to purchase at below fair value
- Lease term is major part of asset's economic life
- PV of minimum lease payments = substantially all the fair value of asset
- Leased assets are of specialised nature
- Change in residual value belongs to lessee
- Rent in second term < market rent

Lessee Accounting for Finance Leases

- Recognise asset as PPE
- Recognise liability for obligation
- Measure asset and liability at lower of:
  - fair value of asset (less grants/tax credit) and
  - present value of minimum lease payments
- Allocate finance charge over period of lease
- Depreciate asset in accordance with IAS 16

Lessor Accounting for Finance Leases

- Recognise receivable
- Measure receivable at lower of:
  – fair value of asset (less grants/tax credit) and
  – present value of minimum lease payments
- Allocate finance income over period of lease
  – net investment method

Accounting for Operating Leases

- Lessee
  - recognise rental payments as expense
  - usually straight-line basis over lease term
- Lessor
  - recognise asset as PPE
  - depreciate asset in accordance with IAS 16
  - recognise income on systematic basis

Sales and Leasebacks

- Is the transaction a sale or a financing?
- If the transaction is a sale:
  - is the lease a finance lease?
  - is the lease an operating lease?
  - are sale price and lease payments at fair value?

Lessee Accounting for Sale and Leaseback

- If lease is finance lease
  - defer any gain and recognise over lease term
- If lease is operating lease - transaction at fair value
  - recognise gain or loss immediately
- If lease is operating lease - sale price > fair value
  - defer any gain and recognise over period of asset's use
- If lease is operating lease - sale price < fair value
  - recognise loss immediately - but defer if compensated by below market value rents

IAS 14 *Segment Reporting*

Key Points

Segment Reporting

- Listed/publicly traded enterprises (only)
- Report information for business and geographical segments
  - segments determined by reference to dominant source and nature of risks and returns
  - segments *usually* reflect internal reporting and organisation structure
  - primary and secondary segments

Segment Reporting

	Primary	Secondary
Sales	√	
Sales (external)	√	√
Revenue (other segments)	√	
Depreciation and amortisation	√	
Other non-cash expenses	√	
Segment result	√	

Segment Reporting

	Primary		Secondary
Segment assets	√		√
Segment liabilities	√		
Capital expenditure	√		√
Business segments - activities	√	**or**	√
Geographical segments - composition	√	or	√
Basis of segment transfers	√		√

Segment Reporting

Three stage approach

- Identify business and geographical segments
  - based on risks and returns
- Are segments reportable segments?
  - based on IAS 14 rules
- Determine primary and secondary segments
  - based on risks and returns

Business Segments

- Distinguishable component engaged in providing product(s) or services
- Product(s) and services subject to risks and returns that are different from those of other business segments
- Usually organisational units for which information reported to board of directors

Geographical Segments

- Distinguishable component engaged in providing product(s) or services within an economic environment
- Economic environment subject to risks and returns that are different from those of other geographical segments
- May be source or destination of goods and services

Reportable Segments

- A segment is a reportable segment if:
  - segment earns majority of revenue from external customers
  - segment's revenue > 10% total revenue of all segments
  - segment's result > 10% total segment result (special rules for losses)
  - segment assets > 10% total assets of all segments
- Identify further reportable segments if total external revenue of reportable segments < 75% total revenue

Primary/Secondary Segments

- Primary segments are:
  - either business segments or geographical segments
  - determined by reference to dominant source and nature of risk and returns
  - normally based on internal reporting structure and system of internal financial reporting
  - usually business segments

IAS 33 *Earnings Per Share*

IAS 33 *Earnings Per Share*

- Disclose
  - basic eps
  - diluted eps

- Similar new standard from FASB

Earnings Per Share

$$\frac{\text{Earnings}}{\text{Weighted average number of shares}}$$

Earnings (Basic EPS)

- Net profit or loss attributable to ordinary shareholders
  - last line in IAS 1 income statement format
  - after tax, extraordinary items etc.
  - after preference dividends

Per Share (Basic EPS)

- Weighted average number of ordinary shares outstanding during period
  – include shares from date on which consideration receivable (usually date of issue)
  – treat partly paid shares as fractions of shares
  – adjust average for all periods for shares issued for no consideration (capitalisation or bonus issue) and bonus element in rights issue

Diluted EPS

- EPS if all dilutive potential ordinary shares had been converted to ordinary shares
- Potential ordinary shares entitle holders to ordinary shares, for example:
  - convertible preference share and convertible debt
  - share warrants and options
  - employee share plans
  - shares to be issued on satisfaction of contractual conditions

Earnings (Diluted EPS)

- Net profit or loss attributable to ordinary shareholders for basic EPS adjusted for:
  - dividends on dilutive potential ordinary shares
  - interest on dilutive potential ordinary shares
  - other changes in income or expenses that would result from conversion of dilutive ordinary shares

Per Share (Diluted EPS)

- Weighted average number of ordinary shares for basic EPS adjusted by:
  - weighted average number of ordinary shares that would be issued on conversion of all dilutive ordinary potential ordinary shares
- Deemed to be converted at later of beginning of period and date of issue

IAS 12 *Income Taxes*

Key Points

Current Tax Expense

- Recognise in period in which profit earned
- Recognise tax recovered on carry back of losses
- Measure using enacted rates
- Recognise and measure using current tax legislation

Deferred Taxes

Old Approach

- Focus on income statement effects
- Timing differences
- Permanent differences
- Liability method *or* deferral method
- Comprehensive *or* partial method

New Approach

- Focus on balance sheet effects
- Temporary differences
  - Taxable
  - Deductible
- Liability method
- Comprehensive

Deferred Taxes

- Compare carrying amount with tax base
- Measure tax assets and liabilities using:
  - tax rates expected to apply when liability settled or asset realised
  - tax rates and tax laws enacted (or substantively enacted) by balance sheet date

Tax Base of an Asset

'… the amount attributed to that asset ... for tax purposes'

IAS 12 (revised), 5

Asset

- amount which will be deductible for tax purposes when any taxable benefits flow to enterprise

Tax Base of a Liability

'… the amount attributed to that ... liability for tax purposes'

IAS 12 (revised), 5

Liability

- carrying amount less any amount which will be deductible for tax purposes

Taxable Temporary Differences

'… differences between the carrying amount … in the balance sheet and ... tax base'

IAS 12 (revised), 5

Taxable temporary differences

- will result in taxable amounts when asset is recovered or liability settled

Deductible Temporary Differences

'… differences between the carrying amount … in the balance sheet and ... tax base'

IAS 12 (revised), 5

Deductible temporary differences

- will result in <u>deductible</u> amounts when asset is recovered or liability is settled

Deferred Tax Liabilities

- Recognise liability for all taxable temporary differences except:
  - some goodwill
  - when temporary difference arises on initial recognition of asset or liability (other than on business combination)
  - (in most cases) on undistributed profits of subsidiaries and associates

Deferred Tax Assets

- Recognise for all deductible temporary differences when it is probable that taxable profits will be available except:
  - some negative goodwill
  - when temporary difference arises on initial recognition of asset or liability (other than on business combination)

Tax Loss Carry Forwards

- Recognise as tax asset to extent probable that future taxable profits will be available
  - sufficient taxable temporary differences
  - taxable profits before losses expire
  - losses result from identifiable causes
  - tax planning opportunities
- Possibly consider IAS 36, 27 for estimates of future cash flows

IAS 19 *Employee Benefits*

Key Points

Employee Benefits

- Short term
  - wages, leave, bonuses
- Post-employment
  - pensions, insurance, healthcare
- Other long-term
  - long service leave, disability
- Termination
- Equity compensation

Short-term Employee Benefits

- Recognise undiscounted amount in period in which service is rendered
- Compensated absences
  - accumulating
  - non-accumulating

Post-employment Benefits

- Formal or informal arrangements
- Employee benefits payable after the completion of employment
- Separate rules for:
  - termination benefits
  - equity compensation benefits
- Defined contribution *or* defined benefit

Defined Contribution Plans

- Enterprise
  - pays fixed contributions into fund
  - no liability to pay further contributions
- Employee
  - takes contributions plus investment returns
  - bears actuarial risk
  - bears investment risk

Defined Contribution Plans

- Recognise contribution payable for service in period as an expense in that period
- Discount contributions due in > 1 year
- Disclose expense for period

- No actuarial valuation required for accounting purposes

Defined Benefit Plan

- Any plan other than a defined contribution plan
- Enterprise
  - obliged to pay agreed benefits
  - bears actuarial risk
  - bears investment risk
- Employee
  - takes agreed benefits

Defined Benefit Plans

- Actuarial valuation required
- Recognise as an expense
  - actuarial cost of providing benefits in respect of service in period
  - interest
- Recognise as income
  - return on any plan assets

Defined Benefit Plans - Complications

- Past service cost
- Actuarial gains and losses
- Gains and losses on plan assets
- Curtailments and settlements
- Transitional provisions in IAS 19
- Restrictions on asset recognition
- Business combinations

Defined Benefit Plans

Present Value of Defined Benefit Obligation

- Present value ….
- … expected future payments …
- … settle the obligation
- resulting from employee service …
- … current and prior periods

Excludes value of plan assets

Defined Benefit Plans

Actuarial Method

- Projected unit credit method

May differ from method used for funding purposes

Defined Benefit Plans

Actuarial Assumptions

- People
  - mortality, turnover, dependants, claim rates
- Benefits
  - future salary and benefit levels, mix of benefits, administration costs
- Return on Plan Assets

May differ from method used for funding purposes

Defined Benefit Plans

Discount Rate

- Market yields on high quality corporate bonds
- Reflect currency and term of benefits
- Reflect timing of benefit payments

May differ from method used for funding purposes

Defined Benefit Plans

Actuarial Gains and Losses

- Experience adjustments
  - assumptions in past have not been borne out by experience
- Changes in actuarial assumptions
  - actual experience in long-term differs from existing assumptions

Defined Benefit Plans

Actuarial Gains and Losses

- Corridor approach
  - gains and losses within 10% corridor not recognised
  - recognise specified portion of gains and losses in excess of 10% corridor
- Any other systematic method
  - must result in faster recognition of gains and losses

Defined Benefit Plans

Past Service Costs

Increase or decrease in obligation arising from introduction of/change in benefits

- Former employees who have retired
  - expense immediately
- Other current and former employees
  - amortise over period to vesting

Defined Benefit Plans

Plan Assets

Held by a legally separable fund to be used only to settle employee benefit obligation

- Measurement
  - fair value
- Returns on plan assets
  - interest, dividends, gains, losses, administration costs
  - actuarial assumption about expected return

Defined Benefit Plans

Curtailments and Settlements

- Curtailments
  - linked with IAS 37 on restructuring provisions
- Gain or loss on curtailment/settlement
  - re-measure obligation and plan assets
  - include unrecognised actuarial gains and losses
  - include unrecognised past service costs
  - recognise when curtailment/settlement occurs

Defined Benefit Plans

Balance Sheet Liability

- Present value of defined benefit obligation
- *plus* unrecognised actuarial gains
- *less* unrecognised actuarial losses
- *less* unrecognised past service cost
- *less* fair value of plan assets

Defined Benefit Plans

Upper Limit on Asset Recognition

Lower of

- Amount determined under liability rules

and

- Unrecognised actuarial losses and past service costs
- *plus* present value of refunds or reductions in contributions

Defined Benefit Plans

Transitional Liability

- Present value of defined benefit obligation
- *less* fair value of any plan assets
- *less* past service costs to be recognised in later periods

- Recognise *increase* over existing liability immediately or over 5 years (maximum)
- Recognise *decrease* in existing liability as change in accounting policy

Other Long-term Benefits

- Recognise liability and expense as service is rendered
- Measure at present value of obligation less fair value of any plan assets
- Recognise immediately as expense/income
  - actuarial gains and losses
  - past service costs

Termination Benefits

- Termination of employment before normal retirement
- Voluntary redundancy in return for benefits

Recognise liability and expense using same criteria as IAS 37 on provisions

Equity Compensation Benefits

- Employee entitles to receive either:
  - employer's equity instruments or
  - benefits based on future price of employer's equity instruments
- No accounting requirements
- Disclosure only

IAS Workshop

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David Cairns